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STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

CITIZENS UTILITIES COMPANY OF ILLINOIS,)
d/b/a CITIZENS WATER RESOURCES)

) Docket No. 01-0645

)
Petition for Certificates of Public Convenience)
and Necessity to provide water and/or sanitary)
sewer service to parcels in DuPage and Will)
Counties, Illinois, pursuant to Section 8-406)
of the Public Utilities Act.)
)

REBUTTAL TESTIMONY

OF

BOB KHAN

REBUTTAL TESTIMONY

OF

BOB KHAN

WITNESS IDENTIFICATION AND BACKGROUND

Q. Please state your name and business address.

A. Bob Khan, Illinois-American Water Company ("IAWC," "Illinois-American" or the "Company"), 1000 Internationale Parkway, Woodridge, Illinois 60517.

Q. Are you the same Bob Khan who prepared Direct Testimony on behalf of Citizens Utilities Company of Illinois ("CUCI" or "Citizens") for purposes of this proceeding?

A. Yes, I am.

Q. Are you aware of a reorganization that has affected Citizens?

A. Yes. On January 15, 2002, after my Direct Testimony was submitted, the water and wastewater assets of Citizens were acquired by Illinois-American, pursuant to authority granted by the Commission in Docket 00-0476. Illinois-American has requested leave to adopt the Petition filed by Citizens in this matter, and to stand in the shoes of Citizens for all purposes in this proceeding. Illinois-American also has assumed the rights and duties of Citizens under the Water and Sewer Service Agreements discussed by Staff witness King. In addition, pursuant to the Order in Docket 00-0476, the rates, rules and

regulation of Citizens in effect at the time of the acquisition continue in effect (until changes are approved by the Commission).

PURPOSE OF TESTIMONY

Q. What is the purpose of your Rebuttal Testimony?

A. The purpose of my Rebuttal Testimony is to respond to the Direct Testimony of Staff witness Roy King.

Q. Are there portions of Mr. King's testimony with which you agree?

A. Yes. Mr. King notes that the Company has demonstrated that construction of the water/sewer extensions is needed to serve the proposed new areas and provide adequate, reliable, and efficient service to customers. Mr. King further testifies that the Company has demonstrated that the proposed construction is the least cost means of providing water/sewer service to customers in the proposed areas. As, Mr. King indicates, Citizens had consistently demonstrated that its water and sewer systems were well operated and that its equipment was well maintained. Mr. King recognized that Citizens was a strong national firm with resources for operations and plant in facilities that were available when and if needed. I agree with Mr. King's testimony in each of these respects.

Q How does the reorganization you described affect Mr. King's observations?

A. Illinois-American is a public utility with a well-established reputation for providing high quality water service. With the addition of the areas previously served by CUCI,

Illinois-American now serves approximately 255,000 water and 32,000 wastewater customers in Illinois. The areas previously served by CUCI now comprise Illinois-American's Chicago Metro Division ("Metro Division"), which is one of four operating Divisions of Illinois-American. Illinois-American's parent, American Water Works Company, Inc., provides water and wastewater utility service and other water resource management services to approximately 12 million people in 28 states and Canada. The acquisition of CUCI by Illinois-American will not adversely affect operation and maintenance of facilities in the area previously served by CUCI in any respect. In fact, IAWC will provide an enhanced level of expertise and resources. As part of the American system, the Metro Division continues to be associated with a strong national firm with resources for operations and plant that are available when and if needed. Thus, Mr. King's observations continue to apply to the Metro Division as operated by IAWC.

THE AGREEMENTS

Q. What is Mr. King's position with regard to the Water and Sewer Service Agreements?

A. With respect to water service and facilities, Mr. King agrees that the Service Agreements are reasonable and in compliance with Section 600.370. Mr. King, however, objects to the Agreements as related to sanitary sewer facilities on the ground that they are unreasonable, as they do not include a provision requiring refunds of the applicant's contributions as customers are attached.

67

68 **Q. What is the basis for Mr. King's position with regard to this issue?**

69 A. Mr. King maintains that, in accordance with the Standards of Service for Water Utilities
70 83 Illinois Admin. Code, Part 600, contributions for sewer facility construction should be
71 subject to refunds. According to Mr. King, this requirement is based on the purpose of a
72 public utility, which, in his view, is to permit a group of investors to invest in necessary
73 utility service and earn a reasonable rate of return on that investment. Mr. King states
74 that regulation is not intended to aid a utility in accumulating significant assets with little
75 or no investment by its stockholders.

76

77 **Q. Would you comment on Mr. King's testimony in this regard?**

78 A. Yes. Mr. King fails to recognize that, when property is contributed to a utility, the cost of
79 that property is deducted from the utility's rate base. Accordingly, although the utility is
80 the owner of the property and responsible for the high cost of maintaining it, the utility
81 does not earn any return on the amount of the contribution. Furthermore, when utility
82 property is sold or otherwise transferred, the contribution is reflected for ratemaking
83 purposes as a deduction to the rate base of the acquiring entity (unless otherwise ordered
84 by the Commission). Therefore, an acquiror of contributed utility plant also is unable to
85 earn a rate of return on the investment in such plant. As a result, from a regulatory
86 standpoint, there is no "windfall" associated with receipt of a contribution.

87

88 **Q. Does the utility reap a “windfall” when contributed property is sold?**

89 A. The price at which property is sold is the amount that a willing buyer pays to a willing
90 seller. This amount is negotiated at arms-length, and is not set by regulation. If
91 shareholders realize a loss on the sale of utility property, it is not the responsibility of
92 ratepayers to absorb all or part of that loss. Similarly, if shareholders realize a gain on
93 the sale of property, that gain is the property of the shareholder.

94
95 **Q. Does Citizens have tariffs in place which govern the receipt of contributions for**
96 **water and sewer main extensions?**

97 A. Yes. For water main extensions, the tariffs of Citizens are consistent with 83 Illinois
98 Admin. Code, Section 600.370(b), which requires, in general, that developers contribute
99 the cost of a proposed extension less one and one-half times the level of revenue expected
100 to be realized from customers who will attach to the extension during the first year of
101 service. Thereafter, for the first ten (10) years after the date of completion of the water
102 facilities, for each new customer who makes application for service and is directly
103 connected to the extension, Citizens refunds to the developer an amount equal to one and
104 one-half times the first year's water revenue generated from that customer. In no event,
105 however, does the total amount of refunds exceed the amount contributed for the
106 extension. With one exception, the tariffs provide for sewer main extensions serving six
107 (6) or fewer residences (when no more than two are under common ownership) under
108 similar terms. The exception is that, under the tariffs, the deposit provided by applicants
109 for sewer service is equal to the full estimated cost of the extension. There is no

deduction of one and one-half times the estimated annual revenue expected from customers who attach during the first year of service. When a sewer service extension serves more than six residences or serves a non-residential customer, the described approach doesn't apply and, as required by the tariff, a special contract must be utilized.

Q. How do the tariffs apply to the five Sewer Service Agreements at issue in this proceeding?

A. The five agreements are for either commercial customers or residential subdivisions with more than six (6) residences. Accordingly, for these extensions, the tariff requires that "special contacts" be established between the Company and the developer.

Q. Is there an established approach for the special contracts required for the other four properties?

A. Yes. As noted above, the other four Service Agreements at issue in this proceeding are characterized under the tariffs as "special contracts." Although the tariffs do not prescribe the terms of such contracts, Citizens has used a consistent approach to such contracts for many years. The form of contract used by Citizens (now the Metro Division) has been approved and/or reviewed by the Commission in many past proceedings. See e.g., Citizens Utilities Company of Illinois, Docket 97-0383 (Jan. 21, 1999) (Commission approved form of sewer service agreement proposed in this proceeding on recommendation of Staff witness King).

132 **Q. Does the form of contract used historically by Citizens provide for refunds payable**
133 **to the developer as customers attach to the extension over a ten year period?**

134 A. No. In my experience, a refund provision of the type required by the tariffs for small
135 residential extensions has seldom been applicable to sewer main extension requests. I
136 can recall only one example of the use of such a provision in my approximately 14 years
137 with CUCL. The vast majority of Sewer Service Agreements are "special contracts" that
138 do not include refund provisions.

139
140 **Q. You noted that the provisions of the tariff with regard to water main extensions are**
141 **consistent with those set forth in 83 Illinois Admin. Code, Section 600.370(b). Is**
142 **there any rule which applies to sewer main extension contributions?**

143 A. No. 83 Illinois Admin. Code, Part 600 applies only to water utilities. There is no
144 reference at all to sewer utility service or facilities in Part 600. In fact, certain of the
145 provisions of Part 600 would, if applied to sewer operations, create dangerous and
146 unacceptable conditions (e.g., Section 600.230, which requires a pressure of 35 pounds
147 per square inch at each customer's service connection). It is clear from a review of its
148 provisions that Part 600 does not apply to sewer utilities.

149
150 **Q. Are there any other Commission rules which dictate the terms which should be used**
151 **in connection with a special contract for sewer facility construction?**

152 A. No, I am not aware of any such rules.
153

154 **Q. If there are no rules, how should the contribution/refund provisions of the special**
155 **contract for the extension of sewer mains be evaluated?**

156 A. In determining an appropriate contribution, the goal is to determine the proper share of
157 the overall investment which should be paid by the applicant for sewer service, on the
158 one hand, and the utility, on the other hand. As noted above, for non-residential
159 applicants (and residential developments with more than six residences), CUCI (now the
160 Metro Division) has for many years relied on established service agreements that do not
161 provide for refunds. The Company believes that CUCI's long-standing approach is
162 necessary to maintain reasonable rate levels for sewer service.

163
164 **Q. What level of investment in sewer facilities has resulted under CUCI's long-standing**
165 **approach?**

166 A. As shown on IAWC Exhibit 1.1R, the utility's investment in sewer facilities as a
167 percentage of gross utility plant is, for the year 2000, 53%. This compares to a utility
168 investment in gross water plant of 71%. It should be noted that, despite the lower
169 percentage of utility investment for sewer facilities, as compared to water facilities, the
170 level of gross plant per customer for water and sewer operations is nearly the same
171 (\$2,763 - water; \$2,669 - sewer). As the data shows, on a per customer basis, sewer
172 facilities cost more to install than do water facilities.

174 **Q. Does the difference in cost for sewer as compared to water facilities explain why the**
175 **special contracts for sewer main extensions do not include refund mechanisms, even**
176 **though refunds are provided in the case of water main extensions?**

177 A. Yes, it does. The Company's experience has been that exclusion of a refund mechanism
178 from special contracts for sewer main extensions is appropriate to maintain a reasonable
179 level of utility investment in new facilities.

180
181 **Q. What would occur if Mr. King's proposed refund mechanism were included in the**
182 **Sewer Service Agreements at issue in this proceeding?**

183 A. Under Mr. King's proposal, the Company would pay a refund to the applicants for
184 service in the amount of one and one-half times the level of revenue expected from each
185 customer attaching to the extension over ten years. As Exhibit 1.2R indicates, this would
186 increase the Company's investment in the extensions involved in this case by \$225,387 or
187 24%. As IAWC Exhibit 1.2 shows, for each new customer attaching to the four
188 extensions, the increased annual revenue requirement that would result from Mr. King's
189 proposal is \$49.20.

190
191 **Q. What is the system-wide effect of adopting Mr. King's approach for the Metro**
192 **Division?**

193 A. As Exhibit 1.1R shows, assuming that Mr. King's refund proposal raises the investment
194 in sewer facilities installations on average by 24%, as is the case here, the result would be
195 additional utility investment system-wide of \$10,894,901, with an associated increase in

196 annual revenue requirement for the Metro Division of \$1,731,276. The annual revenue
197 increase needed to support Mr. King's proposal would be \$47.90 per customer or 14.7%.

198
199 **Q. What percentage level of investment in gross plant would result from adoption of**
200 **Mr. King's proposal?**

201 A. As IAWC Exhibit 1.1.R shows, assuming that Mr. King's ten year refund proposal would
202 increase the investment in utility plant by 24% (as occurs in the present case), the
203 percentage level of the Company's investment in rate base as a percentage of gross utility
204 plant would increase from 53% to 64%.

205
206 **Q. Does it appear that Mr. King was aware of this result of his proposal?**

207 A. No. Mr. King states that, "[t]he refund should be based on the current percentage that
208 Citizens has invested in their own sewer facilities." [emphasis added] The Company
209 agrees that, to maintain reasonable rates, the current percentage level of investment in
210 sewer facilities should be maintained. As I have explained, however, this is simply not
211 possible if a refund mechanism is added to the special contract provisions that historically
212 have not provided for refunds.

213
214 **Q. Is an increased level of utility investment in sewer facilities appropriate as a matter**
215 **of regulatory policy?**

216 A. Absolutely not. Under the present approach, developers contribute much of the cost of
217 initial sewer facility construction, while the utility invests as required in infrastructure

218 improvements and replacement facilities. As demonstrated above, the result of this
219 approach for CUCI has been that (despite the higher percentage level of sewer
220 contributions-47% (sewer); 29% (water)), the level of gross plant per customer for sewer
221 and water operations are roughly comparable. The result of Mr. King's refund proposal
222 would be to drive up the per customer cost of sewer plant and the utility's percentage
223 share of the investment in plant. This result would be wholly inappropriate in an industry
224 that is already the most capital intensive of public utility businesses.

225
226 **Q. Does the approach used in the Agreement for sewer facilities contributions differ**
227 **with regard to refunds from the approach used for water facilities?**

228 A. Yes, it does.

229
230 **Q. What is the reason for the difference in approach?**

231 A. The simple reason for the difference is that, on a per customer basis, sewer collection
232 facilities cost substantially more to build than do water main extensions (as was
233 demonstrated above). As a result, under the tariffs of general applicability, a
234 proportionately higher level of developer contributions to sewer main extensions is
235 required as compared to the level of contributions required for water operations. A
236 proportionately high sewer contribution is needed to maintain reasonable rates.

238 **Q. At pages 10 and 11 of his testimony, Mr. King comments on the approach used for**
239 **contributions by electric/gas utilities as compared to water/sewer. Would you**
240 **comment on Mr. King's testimony in this regard?**

241 A. Yes. Mr. King recognizes that, although electric and gas utilities do not normally receive
242 deposits in connection with the construction of facilities, water and sewer utilities do
243 typically receive contributions. Mr. King further recognizes that the reason for this
244 differentiation is the high level of investment per customer experienced by water and
245 sewer utilities. He further suggests that the "predominance of municipal-owned utilities"
246 is a factor.

247
248 **Q. Would you comment on this testimony?**

249 A. Yes. What Mr. King fails to recognize is that, in addition to the difference he observes
250 between electric/gas utilities on the one hand, and water/sewer on the other, there also is
251 the differentiation discussed above between water and sewer facilities, which also is due
252 to the high level of investment per customer typically required for facilities construction
253 on the sewer side as compared to water.

254
255 **Q. Is Mr. King correct in observing that municipally-owned systems generally receive**
256 **contributions for sewer plant?**

257 A. Yes. Mr. King is correct in noting that municipal entities, which provide wastewater
258 service to the vast majority of Illinois residents, finance wastewater treatment and
259 collection system facilities with developer contributions. These entities also are often

provided with tax-payer supported grants to fund wastewater facility construction. This method of funding enables these entities to construct needed wastewater facilities and, at the same time, mitigate the associated impact on rates for wastewater service.

Q. Does Mr. King indicate that investor-owned utilities should also fund wastewater facilities in this manner?

A. No. Mr. King expresses concern with the possibility that an investor-owned utility may be able to ultimately sell property that was originally contributed at a gain. While this may (or may not) be possible, I believe that Mr. King's concern is misplaced. As discussed above, the proper purpose of regulation is to protect the interest of ratepayers. Furthermore, because the cost of contributed property is deducted from rate base, the receipt of contributions is in the best interest of ratepayers. A regulatory commission should not disregard the interest of utility customers in an effort to deprive shareholders of the opportunity to realize a future gain (which may or may not materialize, and which could be a loss) on the sale of their property.

Q. Who would benefit from Mr. King's proposal?

A. As I have discussed, Mr. King's proposal will disadvantage ratepayers and may disadvantage utility shareholders. The proposal, on the other hand, would create a windfall for developers of property who would no longer be required to contribute the full cost of sewer facilities extensions. Instead, developers, who for years have agreed without complaint to terms comparable to those of the Service Agreements proposed here

(presumably because the price paid to the developers for their property adequately covers the contributions made for utility facilities), would receive refunds as customers attach to the extended facilities. These refunds would be financed by ratepayers through increased rates. Thus, under Mr. King's proposal, the ratepayers face a risk of overpayment, paying once for utility facilities through the purchase price paid to the developer and paying again through rates for the same facilities.

Q. Does this make sense?

A. I don't see how. For the most part, the developers willingly accept the special contract terms, and there certainly has been no groundswell of complaint from any developer or group of developers. I am sure that developers would be happy to accept the refund windfall that Mr. King proposes to distribute. It is the ratepayers, however, who will be required to support Mr. King's proposal through higher rates.

Q. Does that conclude your testimony?

A. Yes it does.

ILLINOIS-AMERICAN WATER COMPANY
Chicago Metro Division

Calculation of Impact on Customer Rates Resulting from Revenue Refunds on Contributed Sewer Plant

	CUCI Year 2000 Form 22 ILCC Reference	Water	Sewer	Combined
Customers:				
Residential	17W / 23S	36,655	33,887	70,552
Non-residential	17W / 23S	1,445	2,244	3,689
Total	17W / 23S	38,100	36,141	74,241
Operating Revenues:				
Residential	17W / 23S	\$ 14,174,054	\$ 9,882,073	24,056,127
Non-residential	17W / 23S	2,554,225	1,919,220	4,473,445
Total	17W / 23S	\$ 16,728,279	\$ 11,801,293	28,529,572
Total Utility Plant (Gross):				
Utility Plant in Service	11F	\$ 89,905,953	\$ 92,782,757	\$ 182,688,710
Plant Held for Future Use	11F	\$ 41,902	\$ 47,139	\$ 89,041
Construction Work in Progress	11F	\$ 15,332,866	\$ 3,615,094	\$ 18,947,960
Total	11F	\$ 105,280,721	\$ 96,444,990	\$ 201,725,711
Total Contributed Plant:				
Advances for Construction	15F	\$ 12,966,654	\$ -	12,966,654
Contributions in Aid of Construction (Gross)	16F	\$ 17,923,532	\$ 45,395,421	63,318,953
Total		\$ 30,890,186	\$ 45,395,421	76,285,607
Total Gross Utility Plant Less Total Contributed Plant (Rate Base)		\$ 74,390,535	\$ 51,049,569	\$ 125,440,104
Rate Base as % of Total Utility Plant (Gross)		71%	53%	62%
Per Customer Statistics:				
Utility Plant (Gross)		\$ 2,763	\$ 2,669	\$ 2,717
Utility Plant (Rate Base)		\$ 1,953	\$ 1,413	\$ 1,690
Operating Revenue		\$ 439	\$ 327	\$ 384
Residential Revenue		\$ 387	\$ 292	\$ 341

Calculation of Impact on Customers Resulting from
Revenue Refunds on Contributed Sewer Plant:

Assumed % of Contributed Plant Restored to Rate Base through Refunds	24%
Amount Restored to Rate Base Through Revenue Refunds	\$ 10,894,901
Authorized Rate of Return from 1995 Rate Order	9.87%
Annual Operating Income Requirement	\$ 1,075,327
Gross-up Multiplier for Income Taxes	1.61
Total Annual Revenue Requirement	\$ 1,731,276

Additional Annual Revenue Requirement per Customer \$ 47.90

% Increase 14.7%

Rate Base (Existing Refund Policy)	\$ 51,049,569
Add Amount Restored to Rate Base Through Revenue Refunds	\$ 10,894,901
Rate Base (with Revenue Refunds)	\$ 61,944,470

Rate Base (with Revenue Refunds) as % of Total Utility Plant (Gross) 64%

ILLINOIS-AMERICAN WATER COMPANY
Chicago Metro Division

Customer Rate Impact of Revenue Refunds on Contributed Sewer Systems

		<u>DuPage</u>	<u>Santa Fe</u>	<u>W. Suburban</u>	<u>Total</u>
A	Estimated Number of Sewer Customers Attaching in 10 Years	0	3	725	728
B	Contributed Plant	\$ -	\$ 36,067	\$ 907,265	\$ 943,332
C	First Year Annual Revenues from New Customers	\$ -	\$ 33,504	\$ 116,754	\$ 150,258
D	Average Annual Sewer Revenue per Customer	C / A			\$ 206
E	Multiplier X First Year Revenues				1.5
F	Amount Restored to Rate Base Through Revenue Refunds	A * D * E			\$ 225,387
G	% of Contributed Plant Restored to Rate Base Through Refunds	F / B			24%
H	Authorized Rate of Return from 1995 Rate Order				9.87%
J	Annual Operating Income Requirement	F * H			\$ 22,246
K	Gross-up Multiplier for Income Taxes				1.61
L	Total Annual Revenue Requirement	J * K			\$ 35,816
M	Additional Annual Revenue Requirement per Customer	L / A			<u>\$ 49.20</u>